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# Debt as a Control Device in Transitional Economies

## The Experiences of Hungary and Poland

*Herbert L. Baer*
*Cheryl W. Gray*

The motivation for most of the reforms debated in transition economies is to impose market-based constraints on enterprise managers, whether through competition or through direct corporate governance. Baer and Gray explore debt's role as a control device in such economies, focusing on Hungary and Poland.

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## Summary findings

The basic economic challenge in the transition from socialism to capitalism is creating incentive structures and institutions that promote enterprise change and restructuring. This is the motivation for most of the reforms debated during the transition — whether privatization, demonopolization, trade reform, or financial sector reform. Most research on corporate governance and privatization has focused on the role of owners — whether on the problems inherent in the separation of ownership and management (most Western literature) or on the need for true owners who represents the interests of capital (most literature on transition economies). But debt is also an important control device, as Western literature on corporate finance increasingly recognizes.

Baer and Gray explore debt's role as a control device in transition economies, focusing especially on Hungary and Poland, which are relatively far along in the reform process. They ask, first, in what ways creditors exert control over firms in advanced market economies and how such control interacts with that exerted by equity holders. They then ask whether creditors in Central and Eastern European countries play similar roles and, if not, what roles they should play, and what can be done to give them the capacity and incentives to play those roles. They focus on three fundamental requirements for debt to function as a control device: information, proper incentives for creditors (including banks, suppliers, and government), and an efficient legal framework for debt collection (including collateral, workout, and bankruptcy regimes). While both countries are making progress in all three areas, there is still much to be done.

Hungary and Poland illustrate only two of many approaches. Other transitional economies, such as the Czech Republic, Estonia, and Russia, are following different approaches that should be explored in future analysis.


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This paper — a joint product of the Finance and Private Sector Development Department and the Transition Economics Division, Policy Research Department — is part of a larger effort in the Bank to explore issues of corporate governance in transition economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Grace Evans, room N11-041, extension 85783 (47 pages). June 1995.

# DEBT AS A CONTROL DEVICE IN TRANSITIONAL ECONOMIES:

## The Experiences of Hungary and Poland

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# DEBT AS A CONTROL DEVICE IN TRANSITIONAL ECONOMIES:

## The Experiences of Hungary and Poland

Herbert L. Baer and Cheryl W. Gray

The most fundamental economic challenge in the transition from socialist to capitalism is creating incentive structures and institutions that promote enterprise change and restructuring. This is the motivation for most of the reforms that are discussed in transition debates, whether privatization, demonopolization, trade reform, or financial sector reform. All of these reforms revolve around one central theme: imposing market-based constraints on enterprise managers, whether through competition or through direct corporate governance. Most research on corporate governance and privatization has focused on role of owners, whether on the problems inherent in the separation of ownership and management (most Western literature) or on the need for true owners who represent the interests of capital (most literature on transition economies). Yet debt is also an important control device, as is increasingly recognized in Western corporate finance literature.

This paper explores the role of debt as a control device in transition economies. It focuses in particular on two countries, Hungary and Poland, that are among the countries farthest along in the reform process. The paper first asks in what ways creditors exert control over firms in advanced market economies, and how such control interacts with that exerted by equity holders. It then asks whether creditors in CEE countries play similar roles, and, if not, what roles they should play, and what can be done to give them the capacity and incentives to play these roles. Although this paper concentrates on Hungary and Poland, the legacy and the resulting shortcomings are similar in many transition economies. Yet Hungary and Poland illustrate only two of many approaches. As discussed in the concluding section of this paper, other transitional economies—such as Russia, Estonia, and the Czech Republic—provide still different approaches that should be explored in future comparative work.

## A FRAMEWORK FOR ANALYSIS

### Debt as a Monitor in Market Economies

Investments in capitalist firms can take two forms: equity and debt. From the perspective of the investor, an important difference between these two is risk. Equity theoretically shares fully in both the successes and the failures of the firm, while debt

receives a fixed return and thus shares much less if at all in the upside or the downside.[1] These roles for equity and debt hold, however, only in situations with full information and no agency costs; i.e. where both owners and creditors know the actual financial condition of the firm and where managers work fully in the interests of these financiers. Corporate governance—i.e. monitoring and control—is necessary to gain access to available information and thereby make informed investment decisions, and to motivate agents to act in the interests of principals. While holders of both equity and debt must monitor to protect their financial investments, the goals, incentives, and capacities that underlie such monitoring differ. Furthermore, the tools at hand to effect monitoring vary, as only equity involves ownership, i.e. the legal right to make management changes. Debt is thus an important, albeit different, control instrument than equity.

As with equity holders,[2] creditors can monitor either actively or passively.[3] The active mode involves hands-on evaluation of a firm's operations and investment decisions. The passive mode depends on collateral for security, and to the extent there is analysis behind a lending decision, it is primarily of the value of the security interest rather than the operations of the firm. In practice, even fully secured lending generally involves some degree of active monitoring on the part of the creditor in advanced market economies, given the significant transaction costs involved in foreclosing on collateral.

Regardless of the form or intensity of oversight, debt plays a different—and in some ways complementary—monitoring role to equity. Corporate finance literature generally views equity investors as less risk-averse, and thus control by equity holders as appropriate for "normal" (i.e. profitable) times, in particular for times where entrepreneurial risk-taking is needed. Owners need to monitor to prevent managerial largess, asset-stripping, or misuse or wastage of retained earnings or free cash flow. Monitoring by equity holders has its inherent weakness, however: it may lead to overly-risky investments at the expense of debt holders, to the extent equity can appropriate all upside gain but shares in any downside loss.

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[1] The main risk to debt in stable market economies--the risk of default (to the extent uncompensated by collateral)--can to some extent be compensated through higher interest margins, which can thus translate into some limited sharing of both downside and upside risks. A second risk to debt, particularly in less stable transition economies, is unanticipated inflation. In environments with high and/or erratic inflation, equity may actually be less risky than debt.

[2] Much of the Western corporate governance literature has contrasted U.S. and German or U.S. and Japanese modes of governance by equity holders. The U.S. system is a model of passive governance, involving primarily entry and exit of investors and disciplining primarily through the indicator of stock price. German and Japanese systems, on the other hand, are more nearly models of active governance or "relational" investing, with monitoring via membership on boards, shareholder voting, and other hands-on means. In the U.S., however, the passive mode can revert to active governance through corporate takeovers, as the purchase of blocks of shares gives new owners the power to change firm policy and management. The mere threat of takeover acts as a powerful control device in many cases.

[3] Holmström (1992) and Holmström and Tirole (1993), as cited in Berglöf (1994).

On the other hand, owners are unlikely to prematurely liquidate firms with long-term potential viability.

In contrast to owners, creditors are expected to be more risk-averse, because they do not share in upside gains. For this reason, creditor monitoring is generally considered to be more appropriate when tight controls on spending and investment are needed, particularly in times of financial distress.[4] Indeed, foreclosure and bankruptcy laws tend to shift control to creditors in such times. However, because of the tendency to risk aversion and short-sightedness on the part of creditors, creditor control carries the danger of premature liquidation of potentially viable debtor firms (the mirror image of the danger of overly-risky investments under owner control).

Within categories of debt, short-term creditors have more control levers at their disposal, and thus tend to exert the strongest control. First, short term credit is by definition refinanced more often, providing more opportunities for creditors to review investment decisions, adjust interest rates to account for risk, or refuse to roll over or grant additional loans altogether. Second, short-term credit is often secured (if at all) by short-term assets (such as inventories or accounts receivable). Foreclosure on these assets is relatively easy, and thus a creditor can easily impose a credible threat of foreclosure (perhaps leading to liquidation of the borrower) if the debt is not repaid. Long-term credit is less flexible, both because of the typically thinner market for long-term assets and because of the creditor's less frequent involvement in roll-over decisions, and thus long-term creditors tend to be weaker, less credible monitors. This partly explains why short-term and long-term credits are often held by different parties, the former by the better and more aggressive monitor.[5]

Even within the category of short-term (or long-term) debt, the monitoring challenge is greater for new credit than for rollovers of existing credit. New credit puts an additional debt-service burden on the debtor firm and is therefore riskier than a rollover. Yet as a source of financing new credit has certain advantages to new equity from a control perspective, because it can encourage optimal effort from managers to the extent they are also owners or otherwise share in upside gains through profit-sharing compensation.

## Legal and Institutional Requirements for Effective Monitoring

Equity and debt monitoring use different mechanisms and are therefore appropriate in different institutional settings. The requirements for good corporate governance by equity holders have been extensively analyzed. Passive monitoring primarily through entry and exit

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[4] Aghion and Bolton (1992) and Hoshi, Kashyap, and Sharfstein (1990). Financial distress can result from intentional actions of agents as well as from impersonal market forces. Just as owners must monitor to prevent asset-stripping by managers, so debtors must also monitor to prevent asset-stripping by owners.

[5] Berglöf and von Thadden (1994).

(as is typical in the U.S., for example) cannot take place unless equity markets are sufficiently deep and unless law and supporting institutions require extensive disclosure to shareholders and provide adequate protection for the interests of minority shareholders. Active monitoring by owners (as in Germany and Japan) depends less on the equity market and underlying institutions, but it still requires supportive corporate laws and adequate disclosure.

The legal and institutional requirements for effective debt monitoring have not been as thoroughly analyzed but are no less important. Passive monitoring by creditors (via collateral contracts) requires, above all, efficient property markets. Such markets in turn require clear legal definition and enforcement of property rights (both existing and contingent), low-cost information (generally via property and collateral registries), and property markets of sufficient size and depth. Active monitoring by creditors relies less on underlying property markets, but it does require sufficient flexibility in debt contracts to allow such monitoring, adequate availability of information via reliable accounting and sufficient disclosure requirements, and workable frameworks for reorganization and liquidation.

Because of these institutional requirements, the degree of active (as opposed to passive) monitoring by owners and creditors may well to be correlated in particular settings. Economies with hands-on owners are more likely to have hands-on creditors, and vice versa. More active monitoring—whether by debt or equity—grows out of other characteristics of the financial and legal systems in a country and in turn reinforces them. For example, active monitoring is generally correlated with stronger banks but weaker capital markets and less onerous public disclosure rules for firms.[6]

Whether debt or equity, the effectiveness of monitoring also depends on the capacities and incentives of the monitors. In the case of equity the capacities and incentives of institutional investors (such as pension funds, mutual funds, or universal banks) are likely to be critical. In the case of debt one must consider the incentives and capacities of bank, trade, and government creditors, as well as other individuals or institutions that may hold publicly traded debt.

In sum, debt and equity play somewhat different, complementary roles. The appropriate balance between debt and equity (i.e. the firm's capital structure) depends, among other factors, on the balance between these various monitoring needs and institutional characteristics.[7] Greater debt might be warranted if (a) the legal framework for debt

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[6] For one attempt to formulate various characteristics of "bank-oriented" vs. "market-oriented" financial systems, see Berglöf (1994).

[7] There are of course many factors other than monitoring needs that also influence the capital structure of firms. For a summary of the literature see Harris and Raviv (1991) and Myers (1989), and for developing countries, Glen and Pinto (1994).

collection is strong; (b) the returns to additional managerial effort are high; (c) there is relatively little downside risk (and therefore interests margins can be modest); (d) there is large risk of misuse of free cash flow by managers (because of agency problems due to the separation of ownership and management); and/or (e) the control powers of equity are weak because of dispersed shareholding, poorly defined shareholder rights, or owners without monitoring competence. In contrast, greater reliance on retained earnings and closely-held equity stakes may be warranted if the legal framework for debt collection (i.e. collateral, foreclosure, and bankruptcy laws and procedures) or monitoring competence of creditors is weak, or if there is large downside risk and thus investors with lower risk aversion are desirable.[8]

## The Need for Creditor Monitoring in Transitional Economies

The framework presented above points out the magnitude of the challenge of developing effective corporate governance in the transition economies of Central and Eastern Europe. Several preliminary "lessons" stand out with regard to the need for monitoring by owners and creditors. First, given the high degree of economic uncertainty (including inflation in many instances) and the "noisiness" of the environment, financing through retained earnings and tightly-held[9] equity investments is likely to be particularly important,[10] and ratios of debt to total assets can be expected to be low under market forces. Debt finance fits uncomfortably in such an environment, and creditors are likely to

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[8] These conclusions regarding capital structure and monitoring needs are drawn largely from theoretical work in corporate finance in recent years. In addition to this theoretical work, there is a small but growing body of empirical work on the role of debt as a control instrument, and on the practice of bankruptcy and/or financial reorganization in advanced market economies. This work, focussed mostly on U.S. experience, attempts to analyze the impact of large increases in leverage on firm performance, the costs of various reorganization routes, the conditions under which reorganization can or cannot successfully occur, and the effects of bankruptcy on the debtor firm. For example, with regard to reorganization routes, Gilson, John and Lang (1990) found that in the U.S. firms with only a few debtors, and no publicly-held debt, have an easier time restructuring out of bankruptcy. Another study by Gilson (1989) found that both bankruptcy and out-of-court debt workouts led to large changes in management and ownership in the affected firms. Hotchkiss (1992) studied 197 companies that successfully completed a Chapter 11 procedure and found significant evidence that the process was biased toward a continuation of firms that should be liquidated. All in all, while creditors clearly have the capacity and incentives to assert strong control over firms in financial distress in the U.S., the literature on U.S. bankruptcy indicates that this control is somewhat weakened due to the pro-debtor provisions embodied in the Chapter 11 bankruptcy reorganization process. In addition to the literature on the U.S., there is also a significant body of literature on the control roles of Japanese main banks and German universal banks (for example, see Sheard (1994), Aoki (1994), and Baums (1994)). It generally supports and underscores the more theoretical treatment summarized above. However, there is virtually no in-depth analytical empirical work that assesses the influence that creditors have over debtors through informal debt workout or bankruptcy processes in those countries.

[9] Equity needs to be tightly-held to avoid the agency problems inherent in dispersed shareholding, particularly if monitoring by debt holders is weak.

[10] McKinnon (1991).

demand large premiums to compensate for the large downside risks inherent in transition, the difficulties of monitoring, and the high costs of debt collection (as discussed later). Furthermore, because the mere existence of debt can make equity holders more willing to take risks, rational creditors will be more hesitant to lend to highly leveraged firms.[11]

Second, even if equity (including retained earnings) serves as the largest source of financing,[12] the complementary control and monitoring roles played by creditors are still needed, particularly given the urgent need for change and restructuring in many firms. For potentially good firms, debt finance can provide incentives for greater effort from owners and managers, allowing them to reap most upside gains. For nonviable firms, creditor monitoring (including refusal of credit when appropriate) is needed to prevent further wastage of resources and to spur exit. For firms with an uncertain future, creditor monitoring is needed to put a brake on overly-risky behavior. In all cases, creditor monitoring is important to the extent equity monitoring remains weak, because the state is the owner, because new owners (especially insiders) are unwilling to cede control to outside equity investors, or because capital markets and/or shareholder rights and disclosure rules are underdeveloped.

Third, creditors should always monitor their investments for their own sake. Owners and managers can strip assets at the expense of creditors, just as managers can do so at the expense of owners. The principal-agent problems inherent in the separation of ownership and management are no less relevant to the conflicts of interest between a firm and its creditors.

## CREDITOR CONTROL IN HUNGARY AND POLAND

While many economic *policies* can be changed overnight, it takes time to develop the complex *institutions* needed for a market economy to function properly. This is nowhere more true than in the financial system, which in market economies operates through a web of complex interlinked rules and institutions. The economies of Central and Eastern Europe are now completing their first half-decade of full-fledged transition, although Hungary and Poland began the process to some extent in the 1980s. The rules and institutions that would be needed for debt to play a strong and independent monitoring role did not exist in the socialist period and therefore must be created virtually from scratch. After a brief look at

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[11] This "lesson" has an important corollary: Transitional economies that develop the proper incentives and institutions to support equity financing and monitoring by owners are likely to prosper compared to those that do not. Privatization policies play a significant role here.

[12] Retained earnings are the largest source of financing even in advanced market economies, but debt levels are still higher than in transition economies (Mayer, 1990).

the structure of enterprise debt, the rest of this section discusses this difficult process of institutional change.

Selected financial data for enterprises in Hungary and Poland for 1992 are shown in Table 1. Three characteristics stand out. First, Polish and Hungarian enterprises, while carrying a significant amount of debt, still tend to have rather moderate ratios of debt to total assets and low ratios of bank debt to total assets.[13] Because 1992 was still an early year in the transition process, much of the debt on enterprise books at that time was carried over from socialism (or was a rollover of debt incurred during socialism) and thus reflected non-market financing processes. However, new flows of voluntary debt finance have been scarce since that time. Macroeconomic constraints in both countries have led to major credit tightening, and the total real value of outstanding bank credit to enterprises has declined since 1991 in both countries (Figure 1).

Second, debt carried on the books of enterprises is not owed exclusively or even primarily to banks. Trade partners and government (i.e. tax, customs, and social insurance agencies) are also significant creditors, albeit often involuntarily. A major category of debt in advanced market economies that has not yet developed on a large scale in the transitional economies is the corporate bond market.

Finally, enterprise debt—even that owed to banks—is overwhelmingly short-term, with maturity periods of less than one year. While to some extent this is also an "accident" of history, it may well persist under market forces because of the need of lenders in this environment to monitor their borrowers through regular review as loans are rolled over.

In sum, enterprises carry substantial amounts of primarily short-term debt to various types of creditors on their books. Does this debt play a significant role as a market-based constraint on managerial behavior? There are three crucial underpinnings to creditor monitoring and control in market economies. These are (1) adequate information, (2) market-oriented creditor incentives, and (3) an appropriate legal framework. To what extent are they now developing, and what lessons can be learned from progress to date?

## The Problem of Information

If debt is to serve as an instrument to influence firm behavior, the first critical requirement is information. While this fact may seem obvious, the constraints imposed by the lack of information in transitional economies must not be underestimated. Viable lending requires that the lender have access to information on the borrower and the capacity to act on that information. Likewise, viable intermediation requires that depositors and/or bank

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[13] These averages, of course, mask differences among individual firms. It is interesting to note that bank debt appears to be quite concentrated in a relatively small number of firms in Poland, whereas it is more evenly spaced among a larger number of firms in Hungary. Gomulka (1992), Bonin and Schaffer (1994).

TABLE 1: Debt Burdens of Hungarian and Polish Firms, 1992

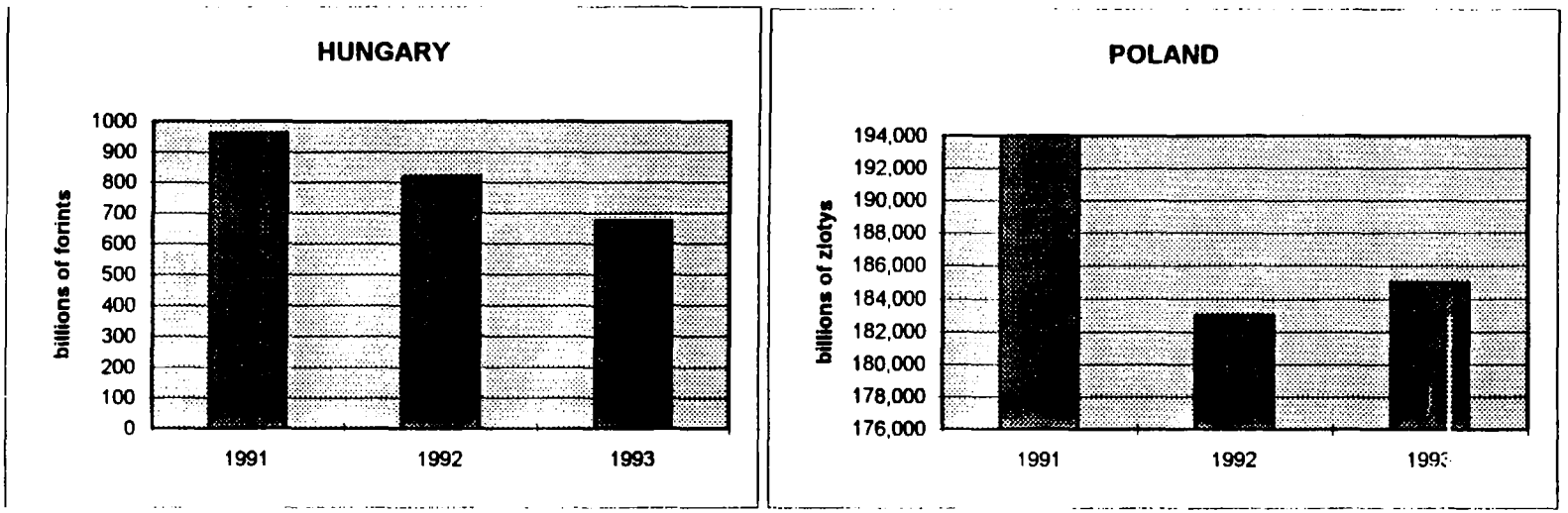
| | HUNGARY | | POLAND | OECD |
|---|---|---|---|---|
| | 57,000 firms | 603 firms (lossmakers) | approx. 200 firms | (range) |
| Total Debt*/Total Assets | .34 | .43 | .41 | .43 - .67 |
| Percentage of Total Debt Owed to: | | | | |
| Banks | | .45 | .24 | |
| Government | | .27 | .16 | |
| Suppliers | | .21 | .36 | |
| Other** | | .07 | .24 | |
| | | 1.00 | 1.00 | |
| Percentage of Total Debt That Is: | | | | |
| Short-term (< 1 year) | 82% | 80% | 86% | 50%-84% |
| Long-term | 18% | 20% | 14% | 16%-50% |

Source: The Polish data is from a survey of approximately 200 firms conducted by a team led by Dr. Marek Belka and financed by a World Bank research project on Enterprise Reform in Eastern Europe. The Hungarian data is from a survey of tax returns carried out by the Hungarian Ministry of Finance. The OECD data is from Rajan and Zingales (1993).

* From other data gathered in the Polish survey, it appears that most of the debts included in "other" in Poland should be allocated to the three earlier categories, primarily "suppliers".

** Total debt includes short-term payables to suppliers and government as well as long-term bank debt.

# Figure 1: Real Bank Credit to Enterprises and Households (1991 prices)



supervisors have access to information on bank portfolios. In Hungary and Poland, as in other transitional economies, information asymmetries—in both firms and banks—are frequently severe.

In the case of enterprises, financial and cost accounting systems were poorly developed prior to transition. As a result, asset values are not well inventoried, and changes in asset holdings may be poorly documented in many firms. In those instances where accurate information systems did exist prior to transition, dramatic changes in the structure of input prices, demand, competition, and distribution channels have reduced the value of this prior information. High tax rates and weak tax enforcement have created strong incentives in both Hungary and Poland for profitable enterprises to mask their performance, further reducing the value of information. Reputation, the basis for much lending in advanced market economies, is of limited value in transitional settings. Private entrepreneurs must build a reputation for integrity from scratch, while the managers of state-owned enterprise with a reputation for integrity may see this reputation devalued. In short, from an information viewpoint, every post-transition firm to some extent is a new firm, even if it has been operating for 50 years.

In addition to shortfalls in accounting systems and the information "chaos" that results from rapid changes in the external environment, information problems are exacerbated in transitional economies by institutional weakness. This is true, first of all, within banks themselves. Many bank employees are not trained in techniques of market analysis and loan appraisal, and thus have difficulty in analyzing and using the information that is available from potential borrowers. This is also true for the financial sector more generally. Even when lending between bank and borrower is viable in theory, for example, the cost and viability of bank intermediation may be threatened by insufficient outside controls on bank management. Monitoring by bank supervisors and/or depositors is needed to counteract fraud, moral hazard, and x-inefficiency among bank owners and employees— public or private.[14] Bank supervisors may lack not only the technical ability but also the political will to carry out tough supervision.[15] Furthermore, the "watchdog" professions, including accounting, law, securities, and credit rating services, are still in their infancy, making it difficult for outside investors to monitor firms or intermediaries or to take any recourse to prevent fraud or misuse of their investment.

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[14] The problems of the Savings and Loan Industry in the U.S. vividly illustrate the sorts of problems that can arise under private as well as public ownership, if supervision is weak and deposit insurance insulates depositors from the incentive to monitor the banks entrusted with their money. Problems also plague the private banking sectors of many transitional economies. One expert has suggested that 90 percent of the private banks in Poland are corrupt and/or insolvent and should be shut down. Many of Russia's private banks are in a similar situation.

[15] Some transition countries have had more aggressive banking supervision that others. Most notable is Estonia, which has forced depositors of insolvent institutions to bear losses. Hungary's banking supervision is generally thought to have been particularly weak during the transition process.

When information asymmetries are significant, adverse selection may make it costly if not impossible for outsiders to fund the growth of a firm with either debt or equity.[16] Enterprises will be forced to rely almost exclusively on retained earnings and injections of capital by insiders.[17] The most profitable enterprises will grow the most rapidly. If lending occurs, it will typically be based on collateral rather than cash flow. Indeed, these patterns to a large extent describe the transition economies today.

## The Problem of Creditor Incentives

The second essential requirement for debt to serve a control function is an appropriate market-based incentive framework for creditors. Before turning to banks, let us look briefly at the incentives of the other creditors listed in Table 1. In Hungary and Poland the principal creditors aside from banks are government and trade creditors. The government creditors include the tax office, the social security service, and the customs office. Debt to these agencies became a substantial portion of the debt on the books of problem firms in Hungary and Poland in the early 1990s. While some of this debt simply reflects payment lags built into law, much of it reflects overdue arrears. These authorities were not known for active law enforcement and collection of arrears; in contrast, their legacy was one of pervasive bargaining and redistribution from profitable and loss-making firms.[18] These habits are not easy to change overnight, although there is some evidence (in part from the authors' discussions with bankruptcy trustees and liquidators) that budget pressures have made government creditors more vigilant in both countries. However, tax and social security arrears clearly are a major source of financing for firms in financial distress.[19] With regard to voluntary credit, governments are poorly positioned to either evaluate and monitor firms or extend large amounts of credit to them. The latter is especially true in Poland and Hungary, where both governments have been under severe budgetary pressures.

As with government debt, a significant portion (although clearly not all) of the debt to trade creditors consists of overdue receivables. Many of these receivables arose in 1991 and 1992, when the enterprise sector in both countries was subject to serious demand and liquidity shocks. These shocks resulted in a stock of inter-enterprise credits that itself undercut discipline due to the fear of "domino" bankruptcies if any one party attempted to collect debts. As with government credit, however, there is evidence that trade creditors are

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[16] See Diamond (1991), for example.

[17] See Myers and Majluf (1984).

[18] Kornai and Matits (1984), Vodopivec (1994), Schaeffer (1990).

[19] Belka, Schaffer, Estrin, and Singh (1994), Bonin and Schaffer (1994).

slowly becoming more active in preventing the emergence of new overdue receivables by requiring payment in advance before goods are shipped to problem firms.[20]

The rest of this discussion on creditor incentives focuses on bank creditors. As noted earlier, credit from banks represents less than half the total liabilities of troubled firms in both Poland and Hungary. Yet banks arguably play the pivotal role among creditors in maintaining borrower discipline. Apart from self-financing and temporary involuntary financing from government, trading partners, and employees through arrears, banks are the only source of financing available now to most Hungarian and Polish firms.

By 1992 many of the state-owned commercial banks in Hungary and Poland were probably insolvent when evaluated using internationally accepted accounting principles. These insolvencies were the result of several factors, including bad loans inherited from the socialist "monobank", transition-induced defaults on existing loans, and defaults on new credits extended after the onset of relative price reform. While part of the problem was "inherited" from the breakup of socialism, much of it arose from post-socialist lending, particularly lending during the 1990-1991 period.[21] Not only was this period particularly difficult economically, with the breakup of the CMEA trading regime and deep domestic recessions in both countries, but the initial post-socialist incentive structure did not encourage banks to expend time or resources cleaning up loan problems and exercising control over their borrowers. While many state-owned enterprises found themselves subject to hard budget constraints, the same could not be said of the state-owned commercial banks. Government decisions to guarantee the deposits of state-owned banks (explicitly or implicitly) in effect exempted the troubled banks from depositor discipline. In practice, state-owned banks in both countries were also exempted from international risk-based capital requirements.[22] Further confusing the situation was the perception that both economies were "underbanked". There were too few branches, too few skilled lenders, and too few resources devoted to providing payments services. While unprofitable enterprises in the manufacturing sector were laying off employees and cutting back production, unprofitable banks were hiring employees and expanding.

Hungary and Poland both responded to the problems in the banking system by moving to reinvigorate existing banks via recapitalization. On the one hand, a one-time recapitalization early in the transition process is arguably necessary (but not sufficient) to establish viable institutions, given the undercapitalized state of most commercial banks when

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[20] Belka, Schaffer, Estrin, and Singh (1994).

[21] Abel (1994) provides supportive data for Budapest Bank.

[22] In Poland, published financial numbers were in violation of the international risk-based capital guidelines until the March 1993 recapitalization. In Hungary, accounting rules prior to December 1991 did not require banks to recognize and provision against their bad loans. Even subsequent to the adoption of the new banking law and implementing regulations in late 1991 and early 1992, anecdotal evidence suggests that banks often continued to roll over loans to large state-owned firms rather than recognize them as problems.

initially separated from the monobank. Undercapitalized banks cannot operate for long without government support and may face perverse incentives to continue distress lending and engage in ever riskier behavior in order to avoid bankruptcy. On the other hand, growing experience from around the world is showing that recapitalization is itself a risky undertaking, particularly if undertaken repeatedly. In the absence of other changes in policies and bank management, recapitalization of insolvent banks may actually make matters worse by skewing incentives even further away from efficient bank restructuring. Bank managers may begin to believe that future losses will also be offset by the government. This will encourage fraud and moral hazard and further undercut the incentives of banks to expend time and energy pursuing delinquent borrowers.

The concurrent adoption of other policies may at least partially offset the adverse consequences of recapitalization by strengthening the market-based incentives facing managers. For instance, when bank recapitalization is conducted in preparation for privatization, competent bank managers may exert additional effort in order to enhance their post-privatization employment prospects. Alternatively, it might be possible to develop incentive systems that motivate managers even in banks that continue to be state-owned. The importance of implicit and explicit incentives cannot be overemphasized. Managers' efforts to maintain their reputations might be sufficient to head off outright fraud. However, if laws and norms on fiduciary responsibility are weak and information on banks' financial status is scant, as it is in all transitional economies, reputation alone may not be enough to lead managers to develop appropriate credit policies, to force turnarounds in delinquent borrowers, or to resist political pressure to extend new credits to ailing state-owned enterprises and politically connected new borrowers. Theoretically, one could design incentive systems to press managers toward fundamental reform.[23] However, the state as owner would have to set up, monitor, and enforce such systems, and most state agencies themselves suffer from similar incentive problems.

While recapitalization is not the only option open to transitional economies (as discussed further in the last section of the paper), it was the option chosen by Hungary and Poland. Experience to date in these two countries illustrates the importance of carefully chosen incentives and appropriate accompanying policies in mitigating the moral hazard inherent in such recapitalization.

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[23] There are two general approaches to the incentive problems inherent in this situation. The first would be to mandate the desired behavior (as opposed to outcomes) through directives or management contracts. Managers that failed to meet their goals would be fired. Managers that met or exceeded their goals would be rewarded. The second approach would be to give managers a claim whose value was tied to the performance of the bank. Possible forms include contracts where the government rewards performance (for instance, performance-based pay) and instruments where performance is rewarded by the market (for instance, warrants to purchase shares of the bank at privatization). Properly constructed, these claims would give managers incentives to identify and undertake actions to increase the bank's value. The two approaches are not mutually exclusive. Management mandates may be necessary to preclude strategies that are clearly against the best interests of the bank (as opposed to its managers), while performance based claims may be necessary to encourage mangers to choose the most effective of a number of possible courses of action.

Hungary's Banking Reforms

Hungary's experience with bank reform until mid-1994 showed relatively little attention to the dangers of potentially negative incentives arising from recapitalization. Hungarian banks were effectively recapitalized four times during that period—in 1991, 1992, 1993, and 1994. In the first of these programs, in 1991, the government issued guarantees for HUF 21 billion (about US$280 million) of doubtful loans, equal to one-half of the doubtful loans that had been transferred to the commercial banks when they were created out of the previous mono-bank in 1987. In the second program, the 1992 Loan Consolidation Scheme, the government purchased HUF 120 billion of the state-owned commercial banks' problem loans for approximately HUF 98 billion (about US$1.2 billion) in state bonds.[24] Of the HUF 120 billion in debt, HUF 41 billion was transferred to a new institution, the Hungarian Investment and Development Rt. (HID), while the remainder stayed with the banks, who were to act as collection agents for the Finance Ministry. HID was envisioned as a collection/workout agency with a mandate to restructure debtor enterprises where possible.

In the third instance, in late 1993, the government implemented a Bank Recapitalization and Loan Consolidation Program, pursuant to which it issued state bonds worth HUF 171 billion (almost US$2 billion) to eight problem banks. Of this, HUF 114 billion was a direct capital infusion, ostensibly to bring banks' capital asset ratios up to 0%, and HUF 57 billion involved government purchases from the banks of the loans of 16 large ailing Hungarian enterprises (plus a large number of smaller agricultural cooperatives) that had been explicitly targeted for rescue. Subsequently, in May 1994, another HUF 16 billion (about US$170 million) was injected into 5 of the 8 banks to raise their CARs to a purported 4%. Finally, the government plans to inject another HUF 20 billion or so into these banks in December 1994 to bring their CARs to 8 percent.

Thus, over 4 years some US$3.4 billion—equivalent to about 9% of 1993 GDP—was injected into Hungarian state banks (and this number is likely to increase still further in the near future). Yet little else was done to create strong and appropriate incentives for bank restructuring. No independent, in-depth portfolio or operations reviews were completed by the government prior to the recapitalizations. Performance-oriented management contracts were not implemented, nor were bank managers given strong and clear incentives to undertake actions that would increase the value of the banks they managed.[25] The

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[24] The numerical figures on the 1992, 1993 and 1994 programs are taken from World Bank data and/or Bonin and Schaffer (1994).

[25] The 1993 recapitalization was ostensibly designed to create incentives for bank-led enterprise restructuring, because it required the banks to enter into workout procedures with certain problem debtors. However, as discussed later in the paper, the government buy-out option included in the plan led some banks to consider the government--rather than the problem debtor--as the main negotiating partner. Although the conciliation process is still ongoing,

government did not formulate a clear plan for state-bank privatization, although two banks (the foreign trade bank and Budapest Bank) have recently undertaken privatization programs largely on their own initiative.[26] Most observers agree that banking supervision has been weak.

Poland's Banking Reforms

The Government of Poland, after a rocky start, appears to have made more significant efforts than Hungary in the four years to mid-1994 to deal with the perverse incentives faced by the managers of a group of state-owned banks. Like Hungary, it opted to recapitalize its commercial state banks, but unlike Hungary, it carried out only one recapitalization (of PLZ 11 trillion, or US$650 million). Furthermore, this recapitalization was embedded in a much larger program designed to change incentives and promote privatization in commercial banks. The program was made credible by the strong and consistent leadership of the Polish Ministry of Finance from 1990 through early 1994.

Changes in incentives began in 1992 and culminated in the adoption of the Enterprise and Bank Restructuring Program ("EBRP") in February 1993. The government sought to affect management behavior both directly and indirectly—directly by mandating certain actions and indirectly by creating incentives to maximize the value of the banks. Direct controls began in the spring of 1992, when the Ministry of Finance actively discouraged banks from making loans to problems debtors. An outright prohibition on such lending was enacted into law with the passage of the EBRP. The policy of prohibiting new lending to nonperforming borrowers had several positive features. It required the government to deal with "strategic" enterprises in a more transparent fashion, placing greater reliance on allocation of subsidies through the budget rather than through the treasury-owned commercial banks. It also created incentives for borrowers to make operational changes in order to survive. With new credit cut off, working capital could only be generated by reducing costs, collecting past due receivables, or selling assets. The EBRP also required banks to set up workout departments and take actions to resolve those loans that had been classified nonperforming at year-end 1991. This again strengthened the banks' hand in negotiations with problem borrowers. In addition, the Treasury-owned commercial banks were required to undergo repeated portfolio evaluations by outside auditors. This forced the creation of management information systems and provided the government with a mechanism for verifying banks' compliance with restrictions on lending to problem borrowers.

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to date it does not appear to have imposed strong market-based incentives on banks.

[26] The foreign trade bank, OTP, was privatized in January 1995. Budapest Bank has not yet succeeded in finalizing a privatization deal. It should be noted that the new government that took office in mid-1994 appears to be intent on moving forward with positive reforms in these areas. It is now undertaking in-depth audits of the banks and is working on a program of bank privatization.

These direct mandates were accompanied by other less direct changes in incentives. In 1992 bank employees were given the right to purchase up to 20 percent of their banks' shares upon privatization at half-price. This strengthened the incentives of competent managers at solvent banks to adopt prudent policies, with respect both to the workout of the existing loan portfolio and to the creation of new loans. Furthermore, the recapitalization was accompanied by a clear plan for privatization of the nine treasury-owned commercial banks. So far three commercial banks have been privatized.[27]

Discussions of the bank recapitalization plan began in 1992, were put into law in February 1993, and were implemented in September 1993. From the outset of discussions, the government sought to determine the amount of capital to be injected based on the value of loans that were nonperforming at year-end 1991. This was designed to avoid penalizing those banks that had already taken aggressive action to deal with their problems and to maintain incentives for managers to oversee other loans in the bank's portfolio.

While Poland's banking policy made greater efforts to deal with incentive problems than did Hungary's, it has been far from perfect. First, large segments of the financial system initially escaped coverage, including the problem-plagued agricultural bank, housing bank, cooperative banks, and private banking sector. Second, Poland's program assumes that bank management is competent and will respond to incentives. There are no explicit criteria governing the dismissal of management for poor performance, and there has been little turnover in bank senior management. Third, while bank policies focus extensively on how to work out bad debts, there are few directives aimed at correcting deficient lending procedures. This leaves open the possibility that a bank can create a large quantity of new bad loans before some sort of preventive action is taken. These shortcomings are of more than academic interest, as at least two treasury-owned commercial banks have continued to deteriorate in 1994.

Banking Performance

Are these differences in policy affecting the way banks behave in general, and how they deal with nonperforming borrowers in particular? While the jury is still out, available data and anecdotal evidence suggest that they could be. Tables 2 and 3 show basic data on the banks that have been the primary focus of reform efforts in the two countries.[28] The differences in the overall capital position of banks in the two countries is striking. Risk-

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[27] Bank Wielkopolski in Wroclaw was privatized in 1993. Bank Slaski in Katowice was privatized in early 1994. BPH in Krakow was privatized in January 1995. To encourage privatization of the commercial banks, donor countries contributed $500 million to the Polish Bank Privatization Fund. As banks are privatized, the funds are released to the Polish government to cover interest payments on the recapitalization bonds. Only banks privatized before March 1996 qualify.

[28] In both cases these banks account for approximately 30 percent of total banking system assets in their respective countries. However, it should be noted that the agricultural loan portfolio, often a source of problem loans, is included in the Hungarian sample but excluded in the Polish sample.

**TABLE 2**
**Financial Data for Seven Polish State-Owned Commercial Banks**

| Year | 1991 | | 1992 | | 1993 | |
|---|---|---|---|---|---|---|
| | billions of zlotys | % of total assets | billions of zlotys | % of total assets | billions of zlotys | % of total assets |
| Total assets | 80,620 | | 119,699 | | 170,874 | |
| Credit to nongovt* | 44,434 | 0.56 | 52,846 | 0.44 | 60,934 | 0.35 |
| Bad Loans** | 14,038 | 0.19 | 17,906 | 0.16 | 19,382 | 0.12 |
| Equity and other capital | 3,452 | 0.043 | 4,040 | 0.034 | 15,086 | 0.088 |
| --minus recapitalization | 3,452 | 0.043 | 4,040 | 0.034 | 3,798 | 0.022 |
| Risk adj. Capital Ratio** | | 0.027 | | 0.039 | | 0.236 |
| Profits after tax | 690 | .0085 | 2621 | .0218 | 7915 | .0463 |
| **Real values (1991=1.00)***** | | | | | | |
| Total assets | 1.00 | | 1.09 | | 1.18 | |
| Loans to nongovt.sector | 1.00 | | 0.87 | | 0.76 | |

* Excludes Central Investment Loans (which are government-guaranteed)
** For six banks only (data on seventh bank not available)
*** Deflated using GDP deflator

**TABLE 3**
**Financial Data for Six Hungarian State-owned Banks**

| Year | 1991 | | 1992 | | 1993 | |
|---|---|---|---|---|---|---|
| | billion forint | % of gross assets | billion forint | % of gross assets | billion forint | % of gross assets |
| Total Gross Assets | 751 | | 805 | | 781 | |
| Credit to Nongovt Sector | 565 | 0.753 | 544 | 0.676 | 519 | 0.664 |
| Loans transferred as part of 1992 LCS | | | | | 98 | |
| Write offs and provisions | 21 | 0.028 | 60 | 0.074 | 158 | 0.202 |
| Equity (before 1993 recap.) | 62 | 0.083 | 27 | 0.034 | -62 | -0.079 |
| Profits after tax | | | -21 | -0.026 | -125 | -0.160 |
| **Real values (1991 = 1.00)*** | | | | | | |
| Total gross assets | 1.00 | | 0.92 | | 0.75 | |
| Credit to nongovt. sector | 1.00 | | 0.82 | | 0.66 | |
| Credit to nongovt. sector including LCS | 1.00 | | 0.82 | | 0.79 | |

* Deflated using GDP deflator

based capital ratios for Poland's seven treasury-owned banks currently range from a low of 9 percent to a high of 45 percent.[29] Excluding the 1993 capital injection, they range from a low of -10 percent to a high of 28 percent, with three of the banks above the six percent level. Excluding the effects of the recapitalization, the equity of the treasury-owned commercial banks as a group remained steady between December 1991 and December 1993, with five of the banks posting significant improvements. In contrast, prior to the year-end 1993 recapitalization, equity levels at Hungary's three largest banks were all negative, and were strongly negative in at least two of the three.[30] Even after the enormous 1993 recapitalization, it has been estimated that equity remained negative for 5 of the 8 banks in the program.[31]

The stronger equity position of banks in Poland is unlikely to result simply from differences in GDP performance or in the competitive environment in the two countries. The shock to GDP was similar in both countries over the 1990-93 period. Furthermore, banks in both Poland and Hungary have operated in less than fully competitive environments, as markets have been fragmented and new entry in banking—particularly by foreign banks—has been controlled (if not prohibited). One potential indicator of competition is the spread between interest rates on demand and time deposits, treasury bills, and loans. Interest spreads in the two countries are shown in Table 4. The data suggest somewhat more competition on the deposit side and perhaps somewhat less competition on the lending side in Poland than in Hungary.[32] However, although spreads are somewhat higher, Poland's rate

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[29] In comparison, the range among U.S. banks is 10 to 18 percent.

[30] Although no exact figures exist, given the absence of detailed audits, estimates of negative bank equity range up to -25% for one of the largest state banks.

[31] Bonin and Schaffer (1994).

[32] Rates on demand deposits are very low in both countries--currently 5 percent in Poland and 3 percent in Hungary. In Poland rates on time deposits are much higher and are above the rates on treasury bills, arguably indicating significant competition in raising funds at the margin. In Hungary, on the other hand, rates on time deposits are almost 6 percentage points below the treasury bill rate, and over 6 percentage points below the interbank rate. This suggests that the market for time deposits in Hungary is, if anything, less competitive than in Poland.

It is more difficult to assess the degree of competition on the lending side of the balance sheet. As of March 1994, spreads between lending rates and treasury bill rates in Poland were much larger than analogous spreads in Hungary. While this could point to a somewhat more competitive banking environment in Hungary, it could also point to hidden fees that increase effective lending rates, greater restrictions on access to lending at those rates, and/or non-profit-maximizing behavior on the part of Hungarian banks. The extremely small spread in Hungary between the riskless rate (on treasury bills) and the rate on much riskier assets (smaller even than in the United States) seems infeasible in a competitive market and is difficult to understand and interpret without further information. Indeed, data on minimum loan rates suggests that at least some short-term loans in Hungary are being priced *below* rates on treasury bills and interbank placements of comparable maturity. Moreover, in Hungary the spread between loan rates and these reference rates has been highly variable, sometimes reaching extraordinarily high levels, and at other times falling to unreasonably low levels.

## TABLE 4

## INTEREST RATES IN POLAND AND HUNGARY

| POLAND | Minimum Loan Rate | Treasury Bill Rate | CD Rate |
|---|---|---|---|
| January 1992 | 45.5 | 43.5 | 42.7 |
| January 1993 | 45.0 | 41.3 | 39.8 |
| January 1994 | 40.6 | 34.9 | 32.9 |
| May 1994 | 39.3 | 32 | 32.4 |

| HUNGARY | Average Rate on New Loans | Minimum Reported Rate on New Loans | Average Treasury Bill Rate | Interbank Rate | CD Rate |
|---|---|---|---|---|---|
| January 1992 | 36.8 | 21 | 31.3 | 35.9 | 31.5 |
| January 1993 | 29.8 | 19 | 15.1 | 17.0 | 17.3 |
| January 1994 | 26.3 | 20 | 23.4 | 22.6 | 17.8 |
| March 1994 | 26.7 | 20 | 23.5 | 23.9 | 17.6 |

structure may in fact better reflect a market-based approach to risk pricing in this high-risk environment.

Although differences in competitive environments may not be of major importance, it is admittedly still difficult to make judgments on relative incentives and performance based on aggregate capital ratios alone. The differences could result from other factors that are not directly comparable. First, they could result from differences in initial positions. Hyperinflation may have eroded away a greater portion of the inherited bad loan portfolio in Poland, or the initial allocation of loans to these Polish banks may have been of higher quality than in the Hungarian case. Second, the differences could result from differences in accounting and provisioning policies. The timing of the rapid deterioration in capital in Hungarian banks has been attributed to the adoption in 1991 of banking and bankruptcy laws that forced a rapid provisioning of existing problem loans (i.e. a recognition of problems that already existed) in 1992 and 1993.[33] In contrast, even as far back as mid-1990 the Polish authorities commissioned diagnostic bank audits based on international accounting standards (even though regulatory capital requirements continued to be calculated using Polish accounting standards), and it is these audited figures that are shown in Table 2. Thus, the Polish year-to-year figures are directly comparable to each other, while the Hungarian figures reflect changes in provisioning policies as well as the underlying quality of the loan portfolio.

All this being said, however, the differences in reported equity of Polish and Hungarian banks cannot be ignored. To the extent that the decline in Hungarian bank equity from 1991 to 1993 reflected continued deterioration in the quality of the loan portfolio rather than merely a recognition of historical losses (due to changes in accounting practices), the differences suggest that Hungary's commercial banks did not stabilize as quickly as Poland's. Furthermore, to the extent the timing of the decline reflected a desire and ability of Hungarian banks to avoid recognizing losses when they initially occurred, this suggests weak incentives[34] and lax supervision. In particular, the banks may have had strong incentives to avoid forcing borrowers into bankruptcy or liquidation, since they would then be forced to provision fully against the bad loans. This may in part explain why one-half of Hungary's largest loss-makers in 1992 had still not entered bankruptcy or liquidation by early 1994. As a third explanation, some have suggested that banks may have overstated their problems in the hope of gaining a larger bailout.[35] While this could in part be true, it is unlikely to account for a large share of the capital deterioration. Any of these explanations raises questions about the efficacy of Hungarian policies on banking reform during that period. The nontransparency of the Hungarian situation, caused in large part by the absence of in-

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[33] Bonin and Schaffer (1994).

[34] Some Polish bank managers may also have desired to hide their losses, but repeated external audits made this more difficult.

[35] Bonin and Shaeffer (1994).

depth external audits of the banks, makes it very difficult to draw firm conclusions and is itself arguably an indication of policy weakness.

## The Legal Framework for Debt Collection

The third critical requirement for creditor monitoring and control in a market economy is an appropriate legal framework and effective procedures for debt collection. Without an effective system of debt collection, debtors lose repayment discipline, the flow of credit is constrained, and creditors may be forced to turn to the state to cover losses if they are to survive. Both Hungary and Poland are still in the early stages of developing market-oriented debt-collection mechanisms, although they have made some initial progress and are arguably further down this path than other reforming socialist economies. However, there is still a long way to go. The basic reality is that it is still quite difficult for creditors to collect unpaid debts in Hungary or Poland, and until this is eased credit cannot be expected to flow freely and efficiently. In addition to problems in some of the laws themselves, the debt collection system is subject to tremendous institutional deficiencies that are typical in transition and will take time to resolve. For example, the courts are understaffed and their personnel underpaid. Judges are often not familiar with bankruptcy principles. Bailiffs are not always well-trained or accountable, and the receiver profession is still in its infancy (particularly in Poland).

For purposes of discussion, the legal framework for debt collection can be divided into three subparts: collateral/secured lending, the workout process, and bankruptcy/liquidation.

### Collateral

In both Hungary and Poland, the laws regarding collateral date essentially from the pre-war period and fail to provide an adequate foundation for a strong financial system or an efficient market economy. The problems are many. First, the definition of property that can be used as collateral is narrow, particularly in Poland. Real property can be the subject of a mortgage, but liens on moveable property are in theory limited by the legal requirement that they be possessory, i.e. that the property subject to the lien be physically in the possession of the lender. In fact lenders appear to be able to circumvent this requirement in practice (for example, by retaining title in the hands of the lender while transferring physical possession to the borrower), but not without some risk.

Second, the registration of liens, needed to inform third parties and thus to establish priority, is inadequate. Mortgages on real property do not present a major legal problem in this regard, as they can be registered in the land records. The real problem with the registration of liens involves moveable property (which are common albeit not wholly envisioned in existing law, as noted above). There is essentially no way to register liens on movables in either country. Thus it is very common to have several liens secured by the

same property. To increase their security in such a situation, banks take liens on far more property than the value of the loan. When everyone secures everything, nothing is in fact secured.

The third major problem in both countries involves priorities of liens. Pursuant to the Polish Code of Civil Procedure, secured creditors come far down in priority, below procedural costs, payments to employees, taxes, and rents due on government-owned property. Furthermore, under other provisions of Polish law, the government has an automatic lien over all property of any party in arrears to the government (for taxes, social security payments, or customs duties). This lien need not be written or formalized in any way to have priority. Since most problem debtors have large arrears to the government, this automatic lien severely impinges on the security provided by any other liens. Furthermore, under current Polish law not the first but the last lien taken on a piece of moveable property has priority, if that lien was taken by the creditor in good faith (i.e. not knowing that other liens existed). This rule contrasts with the "first-in-time-first-in-right" rule typical in market economies. Finally, non-bank secured creditors are at an extreme disadvantage under current Polish law, because all bank loans, whether or not secured, have priority over other creditors, even if the latter are secured.

Although formerly quite reasonable, Hungary's priority scheme has also recently become problematic, although it is still not quite so confused as that of Poland. Under a new law adopted in September 1994[36], Hungarian secured creditors were demoted in priority to come after liens to the government. As the latter can be very high for problem firms, this change severely undercuts the value of collateral in Hungary.

Fourth, the process of execution of liens is fraught with problems in both countries, whether the lien arises from a collateral property right or simply from a court decision that a debt is overdue. Creditors must go to court (or arbitration) to get a decision that the loan is indeed due, which gives them "executory title" to the debtor's property. This can take months. In Poland banks have the right to issue their own executory title,[37] but they still must go to court to have it stamped and thus "perfect" the title (which gives them the right to order the bailiff to attach the property). All creditors must pay the bailiff a large fee up front—reportedly 10 percent of the loan amount in Poland—to begin the actual collection process. Yet once the bailiff receives the money he seems to have little incentive to move speedily, and thus creditors can literally wait years for anything to happen. It is not

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[36] Law #53 on Debt Recovery Through a Court Process.

[37] Changes in Polish law allowing bank lenders to avoid courts in gaining executory title (a prerequisite to foreclosure) have expedited the seizure of collateral. The behavior of other creditors suggests that this procedural shortcut is valuable; privately owned Polish banks, for example, lobbied extensively to have this power, initially reserved for state-owned banks, extended to them. In addition, nonbank creditors now hire banks to conduct foreclosures for them in order to obtain faster execution.

surprising that bailiffs (which apparently constitute a powerful and tight-knit group) have a negative image.

Finally, even if a creditor does succeed in gaining execution on a lien, the market for many assets is thin, and thus it is often not easy to sell the collateral and thus collect on the loan.[38] Even in the case of real property, which one might expect would be easy to sell, much of the property is encumbered by other liens (including tenants' rights) that lower the value and/or marketability of the property. For residential property, for example, it is virtually impossible to evict tenants and sell mortgaged property unencumbered by tenants' liens.

The difficulty in acquiring, registering, and foreclosing on collateral rights has meant that certain kinds of lending are not profitable for lenders. For instance, commercial bank loans collateralized by residential real estate are relatively rare because the current legal system makes foreclosure difficult and costly. Working capital loans and longer term lending for investment are both hindered by the overlapping claims and unclear rights and priorities attached to moveable collateral.

Given these many problems, how easy is it to reform collateral laws and procedures to make collateral finance feasible and attractive in transforming economies? Poland is the first test case, as it has moved faster than any other transforming economy in an attempt to strengthen its collateral system. A modern collateral law has been drafted and debated over the past three years, and a close-to-final draft is ready for consideration by Parliament. This draft reforms the priority rules to eliminate the automatic priority given to government claims, to put secured creditors at the top (albeit after costs of collection), and to remove the preference currently given to banks above other creditors (regardless of who is secured). It also provides for a central registry for all liens on moveable property, and specifies that the first lien to be registered has first priority. Finally, it simplifies somewhat the execution procedure. The draft law is expected to be adopted in 1995.

Debt workouts

A second critical component of the legal framework for debt collection is the procedure for workouts and formal reorganizations.[39] These are means through which a

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[38] Shleifer and Vishny (1992) point out the importance of liquid asset markets and high liquidation values in making collateral effective as a liquidation threat and hence making collateral-based finance attractive.

[39] The major difference between a workout and a formal reorganization is the identity of the parties bound by the resulting agreement. A workout is essentially a renegotiation of one or more debt contracts, carried out pursuant to contract law. It binds only the parties to the relevant contracts. If a firm has only a few important creditors, workouts can be attempted quite easily by negotiating solely with those creditors (and ignoring or buying out the claims of other smaller creditors). However, if a firm has many large and important creditors, or if much of its debt is in the form of bonds owned by the public at large, the transaction costs of dealing with each one individually can be prohibitive (Gilson, 1990).

problem debtor tries to negotiate a reduction in immediate debt service requirements as a means to keep the firm alive. In return for the reduction in debt service, creditors may insist upon partial payments or upon fundamental changes in the size or functioning of the firm in order to increase their chances of future repayment of the remaining debt. From a public policy perspective, these procedures are intended to promote reorganization of firms whose going concern value (post-reorganization) exceeds their liquidation value. Such firms, for example, may have assets (such as specialized machinery or unique trademarks) with little value in alternative settings.

Both Poland and Hungary have taken far-reaching steps since 1991 to adopt market-based workout processes. Poland has two existing procedures for debt workout—one a judicial procedure and the other an extrajudicial one. Judicial debt workouts occur under the law on "Arrangement Proceedings", which provides a means for restructuring a firm's debts, thereby allowing it to continue in operation. This law dates from 1934 (although significant amendments were made in 1990), and its main disadvantage is its extreme inflexibility.[40] In order to overcome the deficiencies inherent in the Arrangement Proceedings law, Poland adopted a new procedure in February 1993 for working out bad loans—the bank conciliation agreement.[41] This new procedure shifts power from the courts and the borrower to the banks. Banks are empowered to negotiate a workout agreement on behalf of all creditors, providing they receive approval of creditors representing over 50 percent of the value of outstanding debt. The conciliation process is being used quite extensively (Table 5), even by banks that were not required to do so under the EBRP. Moreover, the seven Treasury-owned commercial banks are initiating conciliation negotiations with borrowers even in cases when the law does not require action.

Borrowers and/or certain creditors acquire several potential advantages if they opt for restructuring under bank-led conciliation rather than judicial conciliation. First, the process is likely to be somewhat quicker and less cumbersome, because the courts are not involved except to hear an appeal against an agreement. Second, priority rules change. The state Treasury loses its superpriority. Only the social security office and secured creditors retain priority. Third, the ability of a minority of creditors to block agreements is limited. Fourth, responsibility for monitoring the restructuring program is explicitly delegated to the lead

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[40] For example, workouts under this law exclude secured creditors and government creditors (such as tax and social security offices), and thus in most cases the proceeding covers only trade creditors (since banks typically secure their loans). Furthermore, all relevant creditors must be treated identically under the law. The concessions given to different creditors cannot thus be tailored to their specific needs. In addition, the procedure provides only for financial terms in the resulting agreement. Broader restructuring provisions, such as changes in employment, investment, or management, are not envisioned. Finally, only parties attending the proceedings are allowed to vote on the proposed agreement. It may be very difficult for a debtor with many creditors to assemble the required majority in one place for the vote.

[41] For an in depth description, see Kawalec, Sikora, and Rymaszewski (1994) and van Wijnbergen (1993). For a preliminary analysis of results, see Kawalec, et. al. (1994), Belka (1994), and (in Polish) Chmielewski et. al. (1994).

TABLE 5

Outcome of the Poland's Enterprise and Bank Restructuring Program:
The Status (as of April 30, 1994) of Nonperforming Borrowers That Owed Money to 7 Polish Treasury Owned Commercial Banks on December 1991

Status as of April 30, 1994:

| | Percent of 1991 balances | Number of firms |
|---|---|---|
| Signed conciliation agreement | 50% | 202 |
| *--of which partially serviced debt* | *25%* | *98* |
| Resumed scheduled debt service[1] | 19% | 102 |
| Repaid debt | 13% | 211 |
| Entered bankruptcy | 10% | 121 |
| Debt sold or posted for sale | 5% | 89 |
| Entered Article 19 liquidation | 3% | 50 |

[1] Paid past due interest and scheduled repayments of principal. This category includes nominally short term loans that are rolled over.

bank. If the lead bank does not terminate the agreement when the restructuring plan is violated, it becomes liable for any additional losses incurred by the other creditors. Fifth, the range of potential outcomes is broader under conciliation. For example, banks may exchange debt for equity. Finally, if the conciliation agreement is declared void, any concessions by the Treasury or the social security agency are unwound. This gives the borrower and the lead bank strong incentives to develop a reasonable plan.

Hungary is significantly ahead of Poland in developing its judicial workout system, although in practice creditors may still derive relatively little benefit from the law and procedure (due primarily to information and incentive problems discussed above). In 1991 the Hungarian Parliament adopted a tough new bankruptcy/liquidation law that took effect on January 1, 1992. It required managers of firms with any arrears of 90 days or more to file for reorganization (called "bankruptcy" in the Hungarian case) or liquidation. On its face, the 1991 law looks very similar to the reorganization provisions of bankruptcy laws in advanced market economies, particularly Chapter 11 of the U.S. Bankruptcy Code. Managers of bankrupt firms retain their jobs after filing, and have the first opportunity to present a reorganization plan. Creditors then vote on the plan, and have the opportunity to present alternative plans. If an agreement cannot be reached the procedure reverts to liquidation. From the first filing until the final agreement is reached, the courts have relatively little involvement; the main actors are the parties themselves and the trustee (selected by the creditors from a list of licensed trustees/liquidators). The law was amended (effective September 1993) to remove the automatic trigger and change several other significant features of the law.[42]

The 1991 law led to a wave of filings for both reorganization and liquidation (see Table 6). Over 22,000 cases were filed in the two-year period from January 1992 through 1993, including over 5,000 bankruptcy cases and over 17,000 liquidation cases. Resolution of the bankruptcy cases has typically been quite speedy, with more than 90% completed during that period. Liquidation cases take much longer, and most cases filed during 1992-93 are still pending.

In addition to the judicial bankruptcy process, the Hungarians adopted a nonjudicial workout procedure (the "loan consolidation" process) concurrent with the year end-1993 recapitalization in an attempt to force banks to resolve problem loans expeditiously. The number of reorganization filings under the bankruptcy law declined dramatically in 1994, in

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[42] Among other things, the 1993 amendments (1) removed the requirement that a debtor file for bankruptcy if 90 days in arrears, making it instead optional; (2) reduced the required majority for approval of a reorganization agreement from 100% to: a. two-thirds (in value) and b. one-half (in number) of mature claims plus one-fourth (in number) of not-yet-mature claims; (3) allowed the debtor a 90-day moratorium on debt service payments (which was previously automatic) only if the same majority agrees; (4) raised compensation levels for liquidators; (5) required the appointment of a trustee in bankruptcy (which was optional before); and (6) allowed debtors to resort to bankruptcy every 2 years (measured from filing date) rather than only every 3 years (measured from the date of agreement) as it was under the 1991 law.

TABLE 6: Hungarian Bankruptcy and Liquidation Processes
1-92 through 12-93

| | Bankruptcy | Liquidation |
|---|---|---|
| FILINGS | 5,156 | 17,133 |
| Of these: | | |
| SOEs | 429 | 1,820 |
| Cooperatives | 965 | 2,768 |
| Business Entities | 3,762 | 12,545 |
| (of these, limited liability companies) | (2,959) | (8,927) |
| Of these, approximate % | | |
| with over 300 employees | 6% | * |
| 51-300 employees | 24% | * |
| 50 or fewer | 70% | * |
| STATUS AS OF 12-31-93 | | |
| Closed | 4,627 (90%) | ** |
| - With Agreement | 1,250 (27%) | |
| - Reversion to liquidation | 1,377 (30%) | |
| - Administration completion | 2,000 (43%) | |
| Pending | 529 (10%) | |

Source: Ministry of Finance data

* Data not available

** Over 10,000 liquidation cases were completed by the courts in 1992 and 1993, but these included cases filed in earlier years under the previous law. Furthermore, over three-fourths of those completed cases were "administrative completions", i.e. cases withdrawn or rejected on administrative grounds rather than completed on the merits. Only a very small number of the 17,133 cases filed since January 1, 1992 have been completed to date. The law officially gives liquidators two years to finish a liquidation, and that deadline is only now being reached in a significant number of cases.

part due to the changes in the law and possibly in part also due to the adoption of this process. While in theory something like the Polish scheme, in fact the "loan consolidation" process is very different. The process is more akin to a general workout under contract law, in that any agreement binds only those parties that negotiate it—primarily the major banks, with government creditors agreeing to go along on a pro rata basis. In the first round, the so-called "simplified process", involving 55 firms picked by the government (on unclear, seemingly political grounds), representatives of line ministries were invited to participate in the negotiations, and the State Property Agency was given the right to purchase the bad debts of firms from banks if no agreement could be reached in the particular case. Although SPA's resources to buy debt were limited in the first round, the buy back option and the line ministry involvement gave an impression of softness to the process that appears to have reinforced some of the negative incentives discussed earlier and thereby undermined the discipline of both the banks and the enterprises to reach agreement and take difficult steps toward enterprise restructuring. Unlike the Polish conciliation process, the recently added Hungarian nonjudicial procedure does not appear to have strengthened the capacity of debt to serve as a control instrument. To the extent it undermined the developing bankruptcy process, it may even have been a setback.

Liquidation

In addition to being an important means for closing ailing firms, liquidation is the final chain in the debt collection process. Creditors' control rights over firms in financial distress derive ultimately from their power to force the closure of the firm. Yet in many transition economies the laws governing liquidation give little power to creditors (particularly non-governmental ones).

In Poland, the liquidation of financially distressed firms may occur under the Bankruptcy Law ("upadlosc") or under Article 19 of the Law on State Enterprises (see Tables 7 and 8).[43] The Bankruptcy Law is modeled on prewar European statutes, and provides only for liquidation.[44] Creditors or the debtor may file for bankruptcy, a liquidator is appointed, and the law provides standard rules for winding up the estate and satisfying claims in order of priority (as discussed earlier). The law as now designed has several major deficiencies. First and perhaps foremost, the priority list discourages any active involvement by non-government creditors in the bankruptcy process, because it makes

[43] Liquidation privatization, under Article 37 of the Privatization Law, is limited to firms that are healthy as is not considered here.

[44] However, it is possible for the firm to continue operating under the supervision of the liquidator while in liquidation.

Table 7

**Judicial Bankruptcy and Conciliation Procedures in Poland: 1990 - 1992**

| | 1990 | 1991 | 1992 | TOTAL |
|---|---|---|---|---|
| State-owned Enterprises | 8 | 62 | 212 | 282 |
| Communal Enterprises | 0 | 0 | 23 | 23 |
| Cooperatives | 68 | 100 | 152 | 320 |
| Private Enterprises | 87 | 386 | 552 | 1025 |
| Other | 0 | 8 | 1 | 9 |
| **Total** | **163** | **556** | **940** | **1659** |

Source: Polish Central Planning Office (CUP). This office did not collect data on bankruptcies after 1992.

Table 8

**"Exit" Process for Polish State-owned Enterprises (Cumulative through 03-31-94)**

| | | |
|---|---|---|
| Bankruptcies (pending or completed) | 602 | |
| Liquidations (Article 19, State-owned enterprise Law) | 1,125 | |
| Of these: | | |
| Completed | | 203 |
| Converted to bankruptcy | | 258 |
| Taken over by Rural Property Agency | | 51 |
| Pending | | 613 |

Source: Ministry of Ownership Transformation.

it virtually impossible for banks and other creditors to recover anything.[45] Creditors often express the view that "the government always comes first." In fact, if the government and procedural costs do not consume the entire estate, it is likely that employees' claims will. A second deficiency is that the law provides few means for a receiver or judge-commissioner to void fraudulent transactions made by managers or owners, at the expense of creditors, prior to the bankruptcy filing.[46] Fraudulent transactions are indeed thought to be common, and the legal system must find a way to identify and punish them if the bankruptcy process (or indeed any debt collection process) is to be credible.

Article 19 is a legacy of the socialist legal system. Under Article 19, creditors may initiate the liquidation of a state-owned borrower by petitioning the governmental entity charged with exercising ownership control. Liquidation is managed by a trustee charged with selling off the assets in whole or part. Only companies that are still solvent are eligible for this procedure. However, interviews suggest that many of the companies in liquidation prove to be insolvent and ultimately end up in the bankruptcy courts. Lenders may be choosing the Article 19 liquidation because the costs of realizing collateral are lower and because it affords an opportunity to neutralize the superpriority of state claims.

Liquidation procedures in Hungary are contained in the same law as the reorganization (or "bankruptcy") process discussed earlier. As in Poland, the process is a fairly standard one, at least on paper. Creditors or the debtor can petition for liquidation, a liquidator is appointed, a list of assets is drawn up, and the assets are then supposedly sold to satisfy claims in the order of priority. While the Hungarian law does not have the same confused and counterproductive priority rules found in the Polish case (although of all collateral interests only mortgages on real property appear to have priority over unsecured claims), the incentives in the process (particularly the compensation formula for liquidators) appear to lead many liquidators to keep firms in operation for as long as possible, and to act more as restructurers and privatizers than as agents of creditors.[47] Furthermore, the Hungarian process is thought to be compromised by fraud, both on the part of managers

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[45] Although secured creditors can be satisfied first (as in Western bankruptcy law), the priorities among secured creditors themselves are subject to the same priorities outlined in the earlier discussion on collateral, which means that collection fees, taxes and social security arrears automatically precede bank creditors, which in turn precede all nonbank creditors. Once claims secured by collateral are satisfied, the remainder of the assets (and any excess of proceeds from the sale of secured property over the value of secured claims) become the bankruptcy estate. This estate is then used to satisfy creditor claims in the priority specified in the bankruptcy law itself. According to this latter bankruptcy-specific priority, bank and trade creditors come behind (1) the costs of the proceedings (which include all amounts due to the court, the receiver, and employees for wages, severance payments, etc.), (2) taxes, and (3) social security contributions.

[46] The law provides only that *gifts* made within 6 months prior to filing can be voided. It does not extend to sales or other types of contracts (even if they contain an element of gift through underpricing). There is a possibility under the Civil Code to void fraudulent transactions made prior to filing, but such a process is extremely difficult to implement because it requires proof of *intent* to defraud.

[47] Gray, Schlorke, and Szanyi, forthcoming (1995).

(who may remove valuable assets before filing for liquidation) and on the part of liquidators (who can find many ways to profit from their near monopoly control over the process). In Hungary, the problem is not so much the legal framework as it exists on paper as it is the difficulty of administering it properly in an atmosphere with poor information, little accountability, and confused incentives.

## Is Debt Emerging as a Control Device?

The three areas discussed above—information, creditor incentives, and the legal framework for debt collection—are all important in determining the power of creditors to monitor and exert control over managerial decisionmaking. Poland and Hungary have faced similar challenges in all three areas. In the legal area, both have made significant progress in developing workout processes, but they have further to go in streamlining liquidation processes and developing workable systems of collateral. Both liquidation and collateral law appear to be somewhat less developed in Poland than in Hungary, although in the latter area Poland may soon take a big step forward with the passage of a new collateral law. In the area of creditor incentives, Poland's policies to date appear to have imposed stronger market-oriented incentives on its commercial banks. Polish treasury-owned commercial banks as a group have stabilized their overall performance, strengthened their capacity to exert pressure on nonperforming borrowers, and improved their ability to allocate new credit. While data for Hungary is far less complete, the numerical and anecdotal evidence that does exist indicates a less promising picture, in large part due to the moral hazard caused by successive recapitalizations and the absence of mitigating policies to strengthen bank incentives. In both countries banks have been protected not only by segmented markets and entry restrictions, but also (at least in Hungary) by the position of the banks as "monopsonist" buyers of the treasury bills issued to finance government budget deficits.

In sum, it appears that debt is slowly emerging as a control device, although further development and strengthening of information, incentives and legal frameworks are needed if it is to play the important monitoring role (alongside equity) outlined in the first section of the paper. Some empirical support for its slow but steady emergence is presented below.

### Dealing with Nonperforming Borrowers

Data from both countries indicate that banks are sensitive to nonperformance by their borrowers. Since early 1993 the seven Polish treasury-owned commercial banks have made *no* new loans to nonperforming firms.[48] Furthermore, thirteen percent of the loans of those banks that were classified as nonperforming on December 31, 1991 have been repaid in full, another 19 percent have become current on principal and interest, and another 25 or so percent have been partially serviced (Table 5). Thus, borrowers accounting for a total of 57

[48] Internal World Bank data.

percent of loans that were classified as nonperforming on December 31, 1991 have since made partial or full payments to the banks. Although data for Hungary is less complete, some evidence suggests that Hungarian banks, while perhaps continuing to roll over bad debts and capitalize unpaid interest for some nonperforming borrowers, are not offering new money to problem firms on a large scale.[49]

Restructuring Unprofitable Firms

There are also signs that Polish banks are growing in their ability to take an active role in workout situations, and that the restructuring process is being governed, at least in part, by rational economic considerations. In general, Polish banks seem to have approached the conciliation process in a strategic fashion. For example, banks sometimes chose to purchase additional debt in order to qualify for bank-led conciliation. In other cases, where bank loans were secured with valuable collateral, banks waited until unsecured creditors wrote-down their debt under a court-led arrangement proceeding and then initiated bank-led conciliation or a contract renegotiation under the civil code. A number of banks indicated that when they distrusted management, they sought a debt for equity swap so that they would have the option of replacing managers (although this was by no means the only motivation for debt for equity swaps).

Furthermore, initial results indicate a clear correlation between the outcome of the process and the economic prospects of the debtor firm. Data indicate that two-thirds of the firms that have successfully reached conciliation agreements with banks to date have positive operating profits (before interest payments). Another 21 percent are close to the breakeven point and are likely to post operating profits as the Polish economy strengthens. In contrast, the less profitable of the nonperforming borrowers are more likely to be liquidated.[50] Potential profitability may be necessary but does not appear to be sufficient to convince the bankers, however. Workout directors in Polish banks appear to look for a borrower's demonstrated ability to make at least partial payments on its debt before agreeing to a restructuring plan. Indeed, fifty percent of the borrowers signing conciliation agreements appear to have made some payments since December 31, 1991.[51]

In Hungary, there also appears to be a significant push of unprofitable firms into restructuring. Of the 603 largest loss-making firms in the country, almost one-half have been the subject of a bankruptcy or liquidation filing. (Why the other firms in that group are

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[49] Bonin and Schaffer (1994).

[50] In a sample of all problem debtors of two of the seven treasury-owned Polish commercial banks, all of the firms being liquidated through bankruptcy procedures registered negative operating profits in 1992. Firms being liquidated under Article 19 of the Law on State Enterprises appear to be somewhat more profitable than firms being liquidated under the bankruptcy law. In at least a few instances, firms being liquidated under Article 19 improved their operations enough to convince their banks to enter into conciliation agreements.

[51] Internal World Bank data.

not yet subjects of similar filings is an interesting unresolved question.) Initial results from ongoing World Bank research on Hungarian bankruptcy[52] give mixed results as to the effect of the process on enterprise restructuring. On the one hand, financial restructuring appears quite limited in many cases. For example, in the sample of 63 finalized bankruptcy agreements studied, the majority envision only short extensions in the maturity of outstanding debt, often combined with some write-off of debt principal and/or partial repayment of principal or accrued interest. Only 6 of the 63 cases provide for debt for equity swaps, and only three have any provisions for new financing (two from bank creditors and one from suppliers). On the other hand, many of the plans do appear to envision some rationalization of the operations of the debtor firm or at least to have been accompanied by such rationalization. A full 37 of the 63 agreements included some reduction in employment in the debtor firm, and 19 included provisions for either asset sales or sales of part of the firm as a going concern. However, only 4 provided explicitly for a change in top management of the debtor firm, and only 2 for a change in board membership. Along with these substantive results, it is interesting to note that the survey found that managers and/or owners were always active and were often the *de facto* controlling party in the cases, while banks were sometimes active, sometimes passive, but never in control. These preliminary findings suggest that creditors were quite weak in 1992-93 and that the process may indeed have been used in some cases by managers for their own ends—for example, as a means of "spontaneous privatization", as noted below.

Liquidating Unviable Firms

Although workouts are becoming quite common, creditors in both countries are still quite passive when it comes to initiating and overseeing the *liquidation* of nonperforming borrowers. In Hungary, banks have initiated only a handful of the many liquidations cases filed since 1992 (Table 9), and they are reported to behave quite passively in many of the cases that are filed by others. In Poland, banks typically allow other creditors to initiate judicial liquidation proceedings. Once proceedings are initiated, banks typically spend little time overseeing the liquidation. This passivity is in part explained by incentives problems (as discussed above), particularly in Hungary. However, it may also have some economic logic given the low returns that banks can expect to receive from liquidations under present legal frameworks. In Poland the low returns are a consequence of high court fees and the near impossibility of banks' recovering anything given the priority rules described earlier. In Hungary, creditors also appear to doubt their ability to recover any funds under liquidation, not only because of priority problems but also because of opportunities both managers and liquidators have to divert assets and sales receipts. This lack of control may mean that firms are not liquidated until everything of value has been transferred from the firm. Interviews suggest that this is clearly an issue with small privately-owned firms in both Hungary and Poland. Whether this is the case with larger firms remains an open question.

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[52] Gray, Schlorke, and Szanyi, forthcoming (1995).

TABLE 9: Who Files Liquidation Cases in Hungary?
1992 - 1993

| | Percentage of Petitions filed by: |
|---|---|
| Bank Creditors | 1.5% |
| Government Creditors (Tax, Social Security, Customs) | 13% |
| Other Trade Creditors, Liquidators, Conversions from Bankruptcy | 67.5% |
| The Firm Itself | 18% |
| TOTAL | 100.0% |

Allocating New Credit

Evidence on aggregate lending may provide subtle evidence that market-oriented incentives may be stronger for banks in Poland than in Hungary. While commercial banks in both countries have down-sized their loan portfolios and substituted government securities for loans, Poland's commercial banks have done both more aggressively that Hungary's (Figure 2). This is counter to what one might expect if incentives were the same in both countries; given the much lower capital ratios and the slower growth of the economy in Hungary, one might expect Hungary's contraction in lending to be the stronger of the two.

Of the new loans that were made during this period, there is evidence of improvement in the allocation of new credit by certain Polish banks. At least some of Poland's treasury-owned commercial banks have succeeded in implementing effective credit policies. At 5 of the 9 commercial banks created in 1989, default rates on loans not already in default in 1991 have been relatively reasonable (less than 20 percent). Data from the other 4 indicate higher default rates on post-1991 loans, and it is not clear whether the credit allocation process is improving in those cases.

Table 10 presents data on the borrowing patterns of a sample of approximately 200 Polish firms, classified according to the percentage growth in their bank credit. Interestingly, the two extreme categories—firms that repaid all bank debt and firms that increased their debt by over 100 percent—were dominated by profitable firms. Of the firms that did not fully repay their debt (probably in large part because they did not generate as high a level of retained earnings), table 10 indicates that the allocation by Polish banks of new credit in 1993 was positively correlated with the profitability of the borrower.

# Figure 2: Change in Real Lending 1991-1993

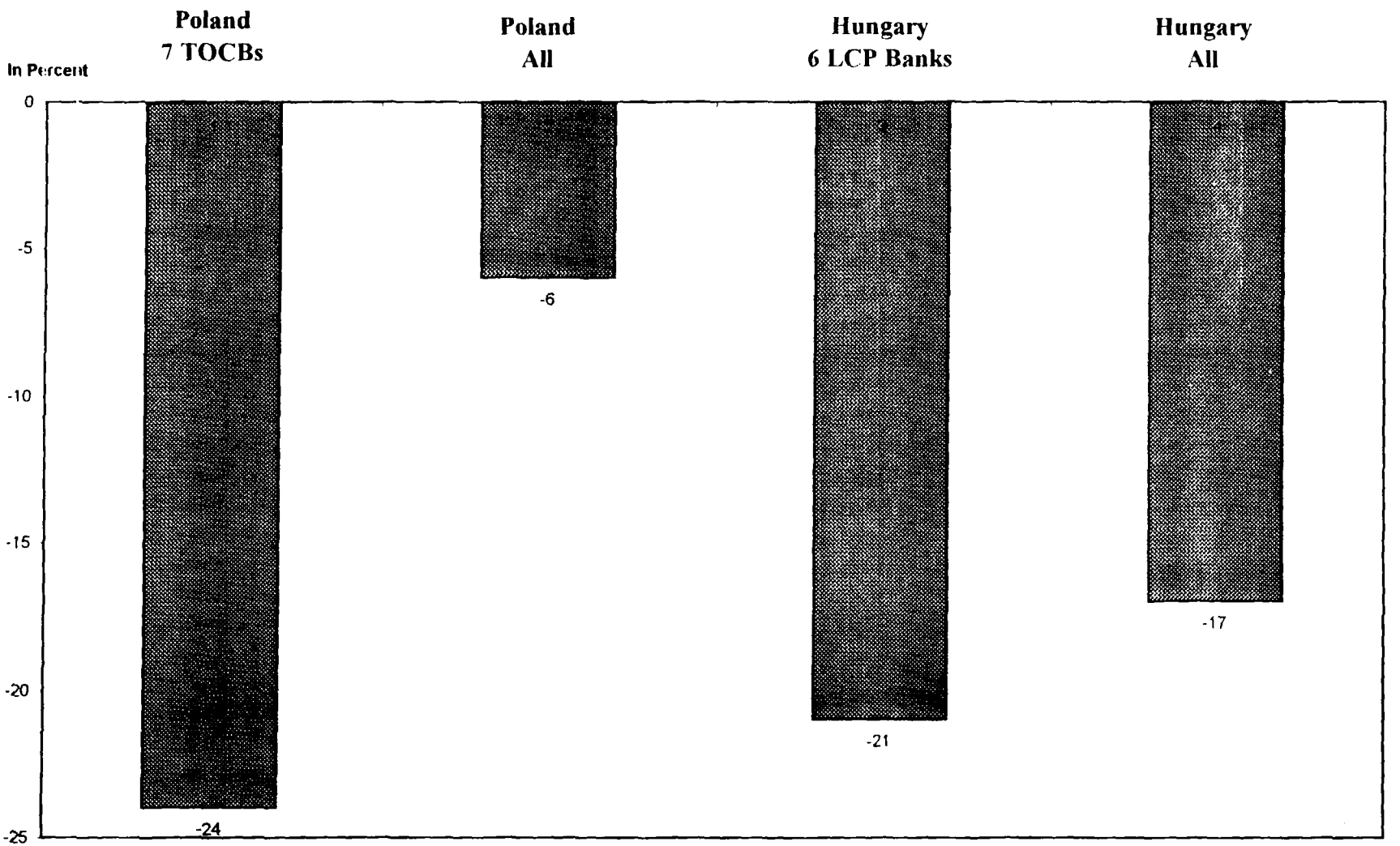

TABLE 10

CHANGES IN BANK CREDIT IN 1993 IN A SAMPLE OF 151 POLISH FIRMS

| CHANGE IN INDEBTEDNESS | Fully Repaid Bank Debt | Decreased Bank Debt (by less than 100%) | No Change in Bank Debt | Increased Bank Debt (by less than 100%) | Increased Bank Debt (by more than 100%) |
|---|---|---|---|---|---|
| Number of firms | 17 | 49 | 12 | 50 | 23 |
| Average profit as a share of total assets | .8% | -10.8% | -6.6% | -4.7% | 0.2% |
| Average bank debt as a share of total assets (1992) | 2.3% | 12.5% | 16.0% | 10.4% | 5.9% |
| Average bank debt as a share of total assets (1993) | 0% | 9.4% | 15.4% | 12.8% | 19.2% |
| Total flow of credit to/from this group (billion zlotys) | -3.4 | -245 | 0 | 450 | 644 |

Source: World Bank Survey

Regression results using this data[53] also indicate that, controlling for profitability, banks preferred to lend to new private firms (as opposed to either state-owned or privatized firms).

The only detailed lending data available for Hungary to date does not cover 1993 and is therefore not directly comparable to the Polish results reported above. (Even in Poland, 1991 and 1992 data may well show different patterns than 1993 data.) Statistics on changes in bank credit in 1992 for a sample of 3273 Hungarian firms compiled by Bonin and Schaffer (1994) indicate that the 5 percent of firms with the lowest profitability increased their total indebtedness in 1992 significantly more than the total sample of firms, although this was primarily due to the capitalization of unpaid interest rather than to any extension of new credit. There is not yet any Hungarian data that indicates a strong correlation between bank lending and firm profitability as in the 1993 Polish figures.

Changing Ownership

Finally, information, incentives, and legal frameworks appear to be interacting in both countries to stimulate some degree of ownership change, albeit in different ways and perhaps for different reasons. In Poland the ownership change arises in part through the bank-led conciliation process. Seven treasury owned commercial banks interviewed by the authors had negotiated 44 conciliation agreements that involved debt for equity swaps, and one of the banks had completed additional debt for equity swaps outside of the conciliation process. However, to date these banks are still state-owned, and thus this ownership change will not

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[53] Numerous regressions were run on the Polish survey data to test the influence of various factors on the allocation of bank credit. One of two dependant variables was used: the change in bank debt of the firm from end-1992 to end-1993 divided by the total assets of the firm (chBD/TA), and the percentage change in bank debt of the firm, end-92 to end-93 (%chBD). Among the independent variables included in the various regressions were the firm's profitability, i.e. return on assets in 1993 (PR93/TA); the share of fixed in total assets in 1993 (FA/TA); the ownership status of the firm (dummy variables NP for new private firm, PRI for privatized firm); the ratio of bank debt to total assets in 1992 (BD/TA92); and the overall size of the firm (TA93). Firms that totally repaid their debt in 1993 were omitted from the sample for purposes of the regressions, in the belief that such repayment may have indicated a lack of demand for credit altogether (and the regressions were intended to test the influence of various factors on the *supply* of credit, assuming demand existed). Although the wide scatter of the data and the generally low R-squares of the regressions indicate that many other factors also influence patterns of bank debt, it is interesting to note that profitability, private ownership, share of fixed assets, and level of indebtedness in 1992 all have some explanatory power (and all have positive signs). Because profitability and private ownership are themselves correlated, the explanatory power of the former drops if the latter is included in the regression. Two of the resulting equations (t-statistics in parentheses) are:

$$\underset{}{\text{chBD/TA}} = \underset{}{-0.016} + \underset{(1.88)}{.059\ \text{PR93/TA}} + \underset{(0.89)}{.041\ \text{FA/TA}} + \underset{(2.39)}{.159\ \text{BD/TA92}} + \underset{(.12)}{.00\ \text{TA}}$$

$$\underset{}{\text{chBD/TA}} = \underset{}{-0.029} + \underset{(1.00)}{.033\ \text{PR93/TA}} + \underset{(1.02)}{.047\ \text{FA/TA}} + \underset{(2.14)}{.045\ \text{NP}} + \underset{(1.58)}{.036\ \text{PRI}} + \underset{(1.51)}{.106\ \text{BD/TA92}} + \underset{(.70)}{.00\ \text{TA}}$$

constitute true privatization until the banks themselves are privatized. In contrast to Poland, the most substantial changes in ownership in Hungary have arisen not from debt for equity swaps (which to date appear to have been rare, as noted above), but rather from the sizeable reallocation of assets (i.e. asset privatization) that appears to be occurring as a result of the many bankruptcy and liquidation cases now reaching fruition.[54]

## Prospects for the Future

The foregoing analysis suggests that Poland has arguably been more successful to date in developing an appropriate policy framework for transforming its state-owned banks into effective financial intermediaries. On the other hand, Hungary has arguably made somewhat more progress in developing debt collection mechanisms that will address the economy's longer-run needs. ***However, it should be stressed that the situation is not static.*** The progress achieved in Poland with bank incentives can be easily undercut if not reversed by a failure to privatize the banks, to strengthen the legal framework for debt collection, or to dislodge poorly performing managers.[55] Furthermore, Hungary's failures in the area of incentives can be reversed with the adoption of a program of in-depth external portfolio audits, clear and credible policies on privatization, safeguards to limit lending to problem borrowers, and an end to "no-fault" recapitalizations. This is no time for complacency in either setting. Greater competition and falling inflation are likely to remove an important source of profits for both banking systems — high spreads on demand deposits (and, in the case of Hungary, time deposits). These spreads have helped banks compensate for their lending mistakes. As these spreads are reduced through competition, the ability to cross-subsidize their lending operations will disappear. Thus, banks in both countries must also concentrate on improving their credit allocation skills.

# BEYOND POLAND AND HUNGARY: OTHER APPROACHES TO REFORM

There has been widespread debate about the best approach to strengthening the role of debt as a control device in transitional economies. Although most observers agree on the need to reform accounting and disclosure standards and take other steps to improve the flow

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[54] While such reallocation is a normal result of workout and liquidation processes in any country, it may be exacerbated in transforming economies because of information asymmetries and insiders' desires to expropriate valuable assets from firms at the expense of creditors and/or owners. For example, managers may deliberately delay payments in order to "qualify" for bankruptcy or liquidation procedures, and then purchase assets sold through liquidation at low prices. Alternatively, managers may transfer valuable assets to private firms and then send the remaining "shell" companies into liquidation. In any case, extensive privatization of assets is likely to result. For further discussion, see Gray (1994).

[55] Unfortunately, recent proposals to consolidate four of the state-owned commercial banks into a single entity may only serve to entrench some poorly performing managers and slow the development of competitive forces.

of information, there is intense debate in the other two areas of reform discussed in this paper. With regard to the legal framework, for example, various approaches to reforms in bankruptcy and debt collection have been put forward,[56] and countries have moved in many different ways and at very different speeds in promoting strong debt collection procedures.[57] This discussion has to some extent mirrored the widespread dissatisfaction with bankruptcy processes in the West,[58] and at the same time has reflected the political and economic tensions associated with rapid change and restructuring in the transition setting.

Most of the controversy to date, however, has surrounded the question of how to reform creditor (particularly bank) incentives. Although this paper has focused on the differences between the Hungarian and Polish programs, both countries have followed a broadly similar approach. This approach can be questioned on at least three fundamental levels: the desirability of relying on government-funded recapitalization to make insolvent banks solvent; the desirability of attempting to make the successors of the old monobanks the cornerstone of a new market-oriented financial system; and the desirability of relying on banks in general to play a significant role in corporate governance and the allocation of financial flows.

Early in the transition process, both Poland and Hungary implicitly committed to protect depositors in state-owned banks by injecting new capital into those banks. Alternatively, insolvent banks could have been "recapitalized" by restructuring the banks' liabilities instead, i.e. by writing down deposits and/or by converting some of the deposits to equity (thereby forcing depositors to share in the loss). In contrast to recapitalization through government injection of new capital, this latter approach results in a shrinkage of the bank to the extent losses on the asset side are reflected in writedowns on the liability side.[59]

Two concerns typically push governments to inject new capital rather than restructure liabilities: fear of a political backlash from depositors, and fear of a system-wide financial crisis.[60] Recent research casts some doubt on the conventional wisdom that forcing depositors to bear loss inevitably risks serious macroeconomic disruption. A recent study identified five cases where governments dealt with significant insolvency problems by

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[56] For examples of different approaches and views, see Aghion, Hart, and Moore (1992), Mizsei (1993), Bonin and Schaffer (1994), and Gray (1994). Still others see the development of secondary debt markets and extensive set-off rights as a way to avoid a reliance on formal debt collection procedures altogether.

[57] The Czech Republic, for example, deliberately delayed the implementation of its bankruptcy regime, in stark contrast to Hungary's aggressive approach.

[58] For example, see Bradley and Rosenzweig (1992).

[59] A combination of some writedown and some injection of new capital is another possibility.

[60] Proponents frequently offer a third argument, the preservation of informational capital. However, this can also be accomplished by restructuring liabilities to bring them into line with decreased asset values.

restructuring bank liabilities.[61] In no case did a significant decline in economic activity result. Indeed, in several cases an economic turnaround began within a month of the restructuring of liabilities. Although the restructuring of liabilities may not have *promoted* macroeconomic growth, these findings indicate that the deleterious effects of liability restructuring were not severe enough to derail recovery.

On a more fundamental level, other observers have questioned whether reform of existing banking institutions is an efficient use of resources, given the huge weight of the socialist legacy. As an alternative they have suggested "creative destruction"—replacing these banks with new banking institutions—with the view that new banks would not carry the burdens of the past and would thus be more likely to internalize the appropriate incentives.[62] Proponents of this view argue that existing state banks should be quickly downsized, their capital being brought to adequate levels by removing assets (or shrinking them through hyperinflation as has already happened in Russia) rather than increasing capital. This view assumes that the corporate governance mechanisms of new private intermediaries will be more effective in avoiding fraud and moral hazard than those of the post-socialist successors of the monobanks.

If the newly chartered banks are clearly outside the safety net, this approach may well be useful in creating new, effective financial intermediaries. However, one cannot readily assume that new banks will initially behave better than old ones if the fundamental underpinnings—information, incentives, and legal frameworks—are not changed. In the early stages of transition, information problems make it difficult to for depositors (or anyone else) to identify private bank owners that are engaged in fraud. For reasons that we do not yet fully understand, countries that liberalize domestic chartering policies almost always fail to follow up with reforms mandating adequate disclosure and creating a well-functioning supervisory system. Ex post legal sanctions are unlikely to be an effective deterrent, given

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[61] Baer and Klingebiel (1994). The cases studied are the United States (March 1933), Japan (1946), Malaysia (1986), Argentina (1989), and Estonia (1992). Estonia's 1992 experience with liability restructuring is informative. In December 1992 the government closed one problem bank and merged two others together. Liabilities were written down in all three cases, with depositors in the closed bank incurring losses and depositors in the other two banks incurring a risk of future loss if problem debts could not be recovered. This program led to no systemic financial crisis. Indeed, in early 1993 Estonia became the first of the FSU economies to post an increase in industrial production, and by the third quarter of 1993 growth in the industrial sector was accompanied by growth in GDP. It is also interesting to note that the liability restructuring, rather than impeding the growth of credit to the private sector, seems to have reversed a year long decline in real credit to the private sector. The Estonian experience suggests that the governments of Eastern Europe could perhaps have restructured their banking systems with considerably less fiscal burden and considerably fewer incentive problems without sacrificing growth. (Political pressures of course play a major role in the choice of strategy. It is interesting to note that depositors were fully protected in the more recent failure of the second largest Estonian bank.)

[62] Phelps, et al. (1993), Pohl and Claessens (1994).

shortfalls in institutional capacity and precedent in the legal system. In this environment, new banking licenses may initially be nothing more than a license to steal.[63]

Of course, neither Hungary nor Poland has fully opened their doors to unhindered foreign investment in the banking sector. Foreign banks can bring capital, skills, reputation, and foreign supervisory practices—assets that can improve the chances that creative destruction, or indeed more traditional banking reforms, can succeed.

Finally, others have questioned the role of banks and credit more generally, suggesting that equity funds should be the primary mechanisms for channeling finance in transition economies. As discussed earlier, however, theory and evidence both reinforce the view that equity and debt each have important, and to some extent complementary, roles to play in monitoring and exerting control over enterprise managers. While debt need not, and probably cannot, play the lead in corporate governance and finance in these economies in the near term, the experiences of the early reformers—Hungary, Poland, and Estonia among them—provide clues as to what must be done to make debt a meaningful control device that can contribute to the enormous task of enterprise restructuring.

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[63] For an interesting discussion of these issues see Akerloff and Romer (1994). The track record of Poland's domestically owned private banks, which are in much worse shape than its state-owned commercial banks, does not give much comfort.

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